STRATEGIC MANAGEMENT
5e

McGraw Hill

FRANK T. ROTHAERMEL

Strategic Management

FIFTH EDITION

Strategic Management

Frank T. Rothaermel

Georgia Institute of Technology

McGraw Hill

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DEDICATION

To my eternal family for their love, support, and sacrifice: Kelleyn, Harris, Winston, Roman, Adelaide, Avery, and Ivy.

—Frank T. Rothaermel

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MINICASES & FULL-LENGTH CASES

MINICASES /

FULL-LENGTH CASES /

The twelve cases included in Connect are noted below. All cases are available through McGraw-Hill Create: www.mcgrawhillcreate.com/rothaermel

* NEW TO FIFTH EDITION, >> REVISED AND UPDATED FOR THE FIFTH EDITION, + THIRD-PARTY CASE

CHAPTERCASES & STRATEGY HIGHLIGHTS

CHAPTERCASES /

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Frank T. Rothaermel, PhD, a Professor of Strategy & Innovation, holds the Russell and Nancy McDonough Chair in the Scheller College of Business at the Georgia Institute of Technology (GT) and is an Alfred P. Sloan Industry Studies Fellow. He received a National Science Foundation (NSF) CAREER award, which "offers the National Science Foundation's most prestigious awards in support of ... those teacher-scholars who most effectively integrate research and education" (NSF CAREER Award description).

Frank's research interests lie in the areas of strategy, innovation, and entrepreneurship. Frank has published over 35 articles in leading academic journals such as the *Strategic Management Journal, Organization Science, Academy of Management Journal, Academy of Management Review,* and elsewhere. Based on having published papers in the top 1 percent based on citations, *Thomson Reuters* identified Frank as one of the "world's most influential scientific minds." He is listed among the top-100 scholars based on impact over more than a decade in both economics and business. *Bloomberg Businessweek* named Frank one of Georgia Tech's Prominent Faculty in its national survey of business schools. The Kauffman Foundation views Frank as one of the world's 75 thought leaders in entrepreneurship and innovation.

Frank has received several recognitions for his research, including the Sloan Industry Studies Best Paper Award, the Academy of Management Newman Award, the Strategic Management Society Conference Best Paper Prize, the DRUID Conference Best Paper Award, the Israel Strategy Conference Best Paper Prize, and he is the inaugural recipient of the Byars Faculty Excellence Award. Frank currently serves or has served on the editorial boards of the *Strategic Management Journal, Organization Science, Academy of Management Journal, Academy of Management Review,* and *Strategic Organization.*

Frank regularly translates his research findings for wider audiences in articles in the *MIT Sloan Management Review, The Wall Street Journal, Forbes,* and elsewhere. To inform his research Frank has conducted extensive fieldwork and executive training with leading corporations such as Amgen, Daimler, Eli Lilly, Equifax, GE Energy, GE Healthcare, Hyundai Heavy Industries (South Korea), Kimberly-Clark, Microsoft, McKesson, NCR, Turner (TBS), UPS, among others.

Frank has a wide range of executive education experience, including teaching in programs at GE Management Development Institute (Crotonville, New York), Georgia Institute of Technology, Georgetown University, ICN Business School (France), Politecnico di Milano (Italy), St. Gallen University (Switzerland), and the University of Washington. He received numerous teaching awards for excellence in the classroom including the GT-wide Georgia Power Professor of Excellence award.

When launched in 2012, Frank's *Strategic Management* text received the McGraw-Hill 1st Edition of the Year Award in Business & Economics. In 2018, the 4th edition of the text received McGraw-Hill's Product of the Year Award in Business & Economics. Frank's *Strategic Management* text has been translated into Greek, Korean, Mandarin, and Spanish. Sixteen of his case studies are Most Popular among the cases distributed by Harvard Business Publishing.

Frank held visiting professorships at EBS University of Business and Law (Germany), Singapore Management University (Tommie Goh Professorship), and the University of St. Gallen (Switzerland). He is a member of the American Economic Association, Academy of Management, and the Strategic Management Society.

Frank holds a PhD degree in strategic management from the University of Washington; an MBA from the Marriott School of Management at Brigham Young University; and is Diplom-Volkswirt (M.Sc. equivalent) in economics from the University of Duisburg-Essen, Germany. Frank completed training in the case teaching method at the Harvard Business School.

PREFACE

The market for strategy texts can be broadly separated into two overarching categories: traditional application-based and research-based. Traditional application-based strategy books represent the first-generation texts with first editions published in the 1980s. The research-based strategy books represent the second-generation texts with first editions published in the 1990s. I wrote this text to address a needed new category—a third generation of strategy content that *combines* into one the student-accessible, application-oriented frameworks of the first-generation texts with the research-based frameworks of the second-generation texts. The market response to this unique approach to teaching and studying strategy continues to be overwhelmingly enthusiastic.

To facilitate an enjoyable and refreshing reading experience that enhances student learning and retention, I *synthesize* and *integrate* strategy frameworks, empirical research, and practical applications with current real-world examples. This approach and emphasis on real-world examples offers students a learning experience that uniquely combines rigor and relevance. As John Media of the University of Washington's School of Medicine and lifelong researcher on how the mind organizes information explains:

> How does one communicate meaning in such a fashion that learning is improved? A simple trick involves the liberal use of relevant real-world examples, thus peppering main learning points with meaningful experiences. . . . Numerous studies show this works. . . . The greater the number of examples . . . the more likely the students were to remember the information. It's best to use real-world situations familiar to the learner. . . . Examples work because they take advantage of the brain's natural predilection for pattern matching. Information is more readily processed if it can be immediately associated with information already present in the brain. We compare the two inputs, looking for similarities and differences as we encode the new information. Providing examples is the cognitive equivalent of adding more handles to the door. [The more handles one creates at the moment of learning, the more likely the information can be accessed at a later date.] Providing examples makes the information more elaborative, more complex, better encoded, and therefore better learned.*

Strategic Management brings conceptual frameworks to life via examples that cover products and services from companies with which students are familiar, such as Facebook, Amazon, Google, Tesla, Starbucks, Apple, McDonald's, Nike, Disney, Airbnb, and Uber. Liberal use of such examples aids in making strategy relevant to students' lives and helps them internalize strategy concepts and frameworks. Integrating current examples with modern strategy thinking, I prepare students with the foundation they need to understand how companies gain and sustain competitive advantage. I also develop students' skills to become successful leaders capable of making well-reasoned strategic decisions in a turbulent 21st century.

I'm pleased to introduce the new 5th edition of *Strategic Management.* My distinctive approach to teaching strategy not only offers students a unique learning experience that combines theory and practice, but also provides tight linkages between concepts and cases. In this new 5th edition, I build upon the unique strengths of this product, and continue to add improvements based upon hundreds of insightful reviews and important feedback from professors, students, and working professionals. The hallmark features of this text continue to be:

- *Student engagement* via practical and relevant application of strategy concepts using a holistic **Analysis, Formulation, and Implementation (AFI) Strategy Framework**.
- *Synthesis and integration* of empirical research and practical applications combined with relevant strategy material to focus on "*What is important?"* for the student and *"Why is it important?"*

*Medina, J. (2014), *Brain Rules: 12 Principles for Surviving and Thriving at Work, Home, and School*. (Seattle: Pear Press), 139–140.

- *Strong emphasis on diversity and inclusion* by featuring a wide range of strategic leaders from different backgrounds and fields, not just in business, but also in entertainment, professional sports, and so forth.
- *Coverage of a wide array of organizations,* including for-profit public (Fortune 100) companies, private firms (including startups), as well as nonprofit organizations. All of them need a good strategy!
- *Global perspective*, with a focus on competing around the world, featuring many leading companies from Asia, Europe, and Latin America, as well as North America. I was fortunate to study, live, and work across the globe, and I attempt to bring this cosmopolitan perspective to bear in this text.
- *Direct personal applications* of strategy concepts to careers and lives to help internalize the content (including the popular **myStrategy** modules at the end of each chapter).
- *Industry-leading digital delivery option* (Create), *adaptive learning system* (SmartBook), and *online assignment and assessment system* (Connect).
- Standalone module on **How to Conduct a Case Analysis**.
- *High-quality* **Cases,** well integrated with text chapters and standardized, *high-quality and detailed teaching notes;* there are three types of cases that come with this text:
  - **12 ChapterCases** begin and end each chapter, framing the chapter topic and content.
  - **12 MiniCases** in Part 4 of the book, with one MiniCase tailored specifically to each chapter with accompanying discussion questions. All of the cases are based on original research, provide dynamic opportunities for students to apply strategy concepts by assigning them in conjunction with specific chapters, and can be used in a variety of ways (as individual assignments, group work, and in class).
  - **22 full-length Cases,** authored or co-authored by Frank T. Rothaermel specifically to accompany this text; 12 of these cases are included complimentary in **5e Connect.**

I have taken great pride in authoring all the case materials that accompany this text. This additional touch is a differentiating feature from other offerings on the market and allows for strict quality control and seamless integration with chapter content. All case materials come with sets of questions to stimulate class discussion and provide guidance for written assignments. High-quality case teaching notes that more fully integrate content and cases are available to instructors in the **Connect Library**.

In addition to these in-text cases, McGraw-Hill's custom-publishing Create program offers all of the cases and teaching notes accompanying the current as well as prior editions (www.mcgrawhillcreate.com/rothaermel).

What's New in the Fifth Edition?

I have revised and updated the new edition in the following ways, many of which were inspired by conversations and feedback from the many users and reviewers of the prior editions.

OVERVIEW OF MAJOR CHANGES IN 5E

- Section "Stakeholder Strategy and Competitive Advantage" now in Chapter 1.
- Section "Vision, Mission, and Values" now in Chapter 2.
- New section "Strategic Decision Making" in Chapter 2.
- New section "From External to Internal Analysis" in Chapter 4.

- Three new **ChapterCases:** Five Guys (Chapter 4), Alphabet and Google (Chapter 11), and Theranos (Chapter 12); all other ChapterCases revised and updated.
- All new or updated and revised **Strategy Highlights** (two per chapter).
- Revised and updated module on **How to Conduct a Case Analysis**.
- Five new **MiniCases** (Uber, PayPal, JCPenney, GE, and BlackBerry), featuring not only success stories but also failures; all other MiniCases revised and updated. One MiniCase per chapter, tightly integrated with learning objectives. Detailed and high-quality teaching notes are available in the Connect Library.
- Three new **full-length Cases** (Airbnb, Nike, and The Vanguard Group); all other cases including most popular ones such as Amazon, Apple, Best Buy, Facebook, McDonald's, and Tesla, among others, are revised and updated. Detailed and updated case teaching notes, as well as financial data for these cases, are available in the Connect Library.

IN DETAIL

CHAPTER 1

- Revised and updated ChapterCase: "Tesla's Secret Strategy"
- New Strategy Highlight: "Does Twitter have a Strategy?"
- New Strategy Highlight: "Merck's Stakeholder Strategy"
- Improved chapter flow through moving the updated section "Stakeholder Strategy and Competitive Advantage" into Chapter 1 (from Chapter 2)

CHAPTER 2

- Revised and updated ChapterCase: "Leadership Crisis at Facebook?"
- New section: "Strategic Decision Making"
- New exhibit: "Two Distinct Modes of Decision Making"
- New exhibit: "How to Use a Devil's Advocate to Improve Strategic Decision Making"
- New Strategy Highlight: "Teach for America: How Wendy Kopp Inspires Future Leaders"
- Improved chapter flow through moving the updated section "Vision, Mission, and Values" into Chapter 2 (from Chapter 1)

CHAPTER 3

- Revised and updated ChapterCase: "Airbnb: Disrupting the Hotel Industry"
- New Strategy Highlight: "Blockbuster's Bust"
- New Strategy Highlight: "From League of Legends to Fortnite: The Rise of e-Sports"

CHAPTER 4

- New ChapterCase: "Five Guys' Core Competency: 'Make the Best Burger, Don't Worry about Cost'"
- New section: "From External to Internal Analysis"
- New Strategy Highlight: "Dr. Dre's Core Competency: Coolness Factor"

CHAPTER 5

- Revised and updated ChapterCase: “The Quest for Competitive Advantage: Apple vs. Microsoft”
- New Strategy Highlight: “PepsiCo’s Indra Nooyi: Performance with a Purpose”

CHAPTER 6

- Revised and updated ChapterCase: “JetBlue Airways: En Route to a New Blue Ocean?”
- New Strategy Highlight: “Cirque du Soleil: Finding a New Blue Ocean?”

CHAPTER 7

- Revised and updated ChapterCase: “Netflix: Disrupting the TV Industry”
- New Strategy Highlight: “Wikipedia: Disrupting the Encyclopedia Business”

CHAPTER 8

- Revised and updated ChapterCase: “Amazon's Corporate Strategy”
- New Strategy Highlight: “P&G Diversification Strategy: Turning the Tide?”

CHAPTER 9

- Revised and updated ChapterCase: “Little Lyft Gets Big Alliance Partners and Beats Uber in Going Public”

CHAPTER 10

- Revised and updated ChapterCase: “IKEA: The World’s Most Profitable Retailer”
- New Strategy Highlight “Does GM’s future lie in China?”

CHAPTER 11

- New ChapterCase: “‘A’ is for Alphabet and ‘G’ is for Google”
- New exhibit: “Formal and Informal Building Blocks of Organizational Design”
- New Strategy Highlight: “Zappos: Of Happiness and Holacracy”

CHAPTER 12

- New ChapterCase: “Theranos: Bad Blood”
- New Strategy Highlight: “HP’s Board Room Drama and Divorce”
- New Strategy Highlight: “VW’s Dieselgate: School of Hard NOx”

MINICASES

- 12 MiniCases, one for each chapter; each MiniCase is closely tied to the chapter’s learning objectives and includes discussion questions and detailed teaching notes.
- Five new MiniCases: Uber, PayPal, JCPenney, GE, and BlackBerry
- The most popular MiniCases from the prior editions have been updated and revised.

FULL-LENGTH CASES

- Three new full-length cases (Airbnb, Nike, and The Vanguard Group); all other cases, including most popular ones such as Amazon, Apple, Best Buy, Facebook, McDonald's, and Tesla, are updated and revised.
- Detailed and updated case teaching notes as well as financial data for these cases are available for instructors in the Connect Library.

CONNECT

- **12 full-length Cases are now included—complimentary—for students in 5e Connect.** Detailed case teaching notes are available in the Connect Library. All full-length cases included in 5e Connect were authored by Frank T. Rothaermel.

Connect, McGraw-Hill's online assignment and assessment system, offers a wealth of content for both students and instructors. Assignable activities include the following:

- **SmartBook**, one of the first fully adaptive and individualized study tools, provides students with a personalized learning experience, giving them the opportunity to practice and challenge their understanding of core strategy concepts. It allows the instructor to set up all assignments prior to the semester, to have them auto-released on preset dates, and to receive auto-graded progress reports for each student and the entire class. Students love SmartBook because they learn at their own pace, and it helps them to study more efficiently by delivering an interactive reading experience through adaptive highlighting and review.
- **Application Exercises** (such as Whiteboard Animation video cases, MiniCase case analyses, click-and-drag activities, and new case exercises for all 12 full-length cases that are available in Connect) require students to apply key concepts, thereby closing the knowing and doing gap, while providing instant feedback for the student and progress tracking for the instructor.

INSTRUCTOR RESOURCES

The **Instructor Resources** located in **Connect** provide the following teaching tools, all of which have been tested and updated with this edition:

- The **Teacher's Resource Manual (TRM)** includes thorough coverage of each chapter, as well as guidance for integrating **Connect**—all in a single resource. Included in this newly combined TRM, which retains favorite features of the previous edition's Instructor's Manual, is the appropriate level of theory, framework, recent application, additional company examples not found in the textbook, teaching tips, PowerPoint references, critical discussion topics, and answers to end-of-chapter exercises.
- The **PowerPoint (PPT)** slide decks, available in an accessible version for individuals with visual impairment, provide comprehensive lecture notes, video links, and additional company examples not found in the textbook. Options include instructor media-enhanced slides as well as notes with outside application examples. All slides can be edited by individual instructors to suit their needs.
- The **Test Bank** includes 100 to 150 questions per chapter, in a range of formats and with a greater-than-usual number of comprehension, critical-thinking, and application or scenario-based questions. Each question is tagged to learning objectives, Bloom's Taxonomy levels, and AACSB compliance requirements. Many questions are new and written especially for this new edition.

- The **Video Guide** includes video links that relate to concepts from chapters. The video links include sources such as Big Think, Stanford University's Entrepreneurship Corner, The McKinsey Quarterly, ABC, BBC, CBS, CNN, ITN/Reuters, MSNBC, NBC, PBS, and YouTube.

CREATE

- **Create**, McGraw-Hill's custom-publishing tool, is where you access additional full-length cases (and Teaching Notes) beyond those included complimentary in Connect that accompany *Strategic Management* (http://www.mcgrawhillcreate.com/Rothaermel). You can create customized course packages in print and/or digital form at a competitive price point.
- Through Create, you will be able to select from all author-written cases as well instructor-written cases that match specifically with the new 5th edition. Create also contains cases from Harvard, Ivey Darden, NACRA, and much more! You can assemble your own course, selecting the chapters, cases (multiple formats), and readings that will work best for you, or choose from several ready-to-go, author-recommended complete course solutions, which include chapters, cases, and readings, preloaded in Create. Among the preloaded solutions, you'll find options for undergraduate, MBA, accelerated, and other strategy courses.

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Any list of acknowledgments will always be incomplete, but I would like to thank some special people without whom this product would not have been possible. First and foremost, my wife, Kelleyn, and our children: Harris, Winston, Roman, Adelaide, Avery, and Ivy. Over the last few years, I have worked longer hours than when I was a graduate student to conduct the research and writing necessary for this text and accompanying case studies and other materials. I sincerely appreciate the sacrifice this has meant for my family.

The Georgia Institute of Technology provides a conducive, intellectual environment and superb institutional support to make this project possible. I thank Russell and Nancy McDonough for generously funding the endowed chair that I am honored to hold. I'm grateful for Dean Maryam Alavi and Senior Associate Deans Saby Mitra and Peter Thompson for providing the exceptional leadership that allows faculty to focus on research, teaching, and service. I like to thank my colleagues at Georgia Tech—all of whom are not only great scholars but also fine individuals whom I'm fortunate to have as friends: Marco Ceccagnoli, Annamaria Conti, Anne Fuller, Jonathan Giuliano, Stuart Graham, Matt Higgins, David Ku, John McIntyre, Alex Oettl, Pian Shu, Eunhee Sohn, and Laurina Zhang.

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I'm more than grateful for the contributions of great colleagues on various resources that accompany this new edition of *Strategic Management*:

- John Burr (Purdue University) on the *Video Guide.*
- Carla Flores (Ball State University) on the revision of Connect, including the *Interactive Exercises*, *MiniCase Exercises*, and *Case Exercises*.
- Melissa Francisco (University of Central Florida) on the accessible *PowerPoint* slide decks.
- Anne Fuller (Georgia Institute of Technology) on *Teacher Resource Manual, Discussion Questions,* and *myStrategy* boxes.
- Gita Mathur (San Jose State University) on *MiniCase Teaching Notes*.
- Chandran Mylvaganam (Northwood University) on selected *Case Abstracts* and *Case Teaching Notes.*

Last, but certainly not least, I wish to thank the reviewers and focus group attendees who shared their expertise with us, from the very beginning when we developed the prospectus to the new teaching and learning package that you hold in your hands. The reviewers have given us the greatest gift of all—the gift of time! These very special people are listed starting on page xxi.

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This book has gone through McGraw-Hill Education's thorough development process. Over the course of several years, the project has benefited from numerous developmental focus groups, hundreds of reviews from instructors across the country, and beta-testing of the first-edition manuscript as well as market reviews of subsequent editions on a variety of campuses. The author and McGraw-Hill wish to thank the following people who shared their insights, constructive criticisms, and valuable suggestions throughout the development of this project. Your contributions have greatly improved this product:

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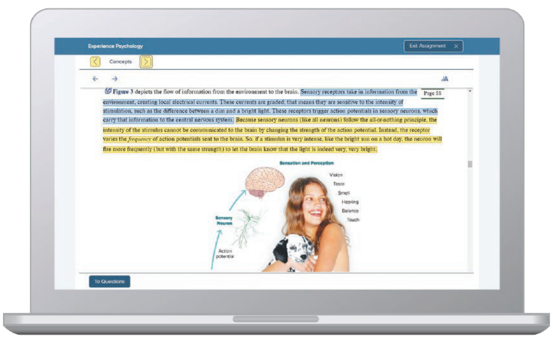

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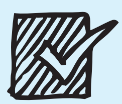

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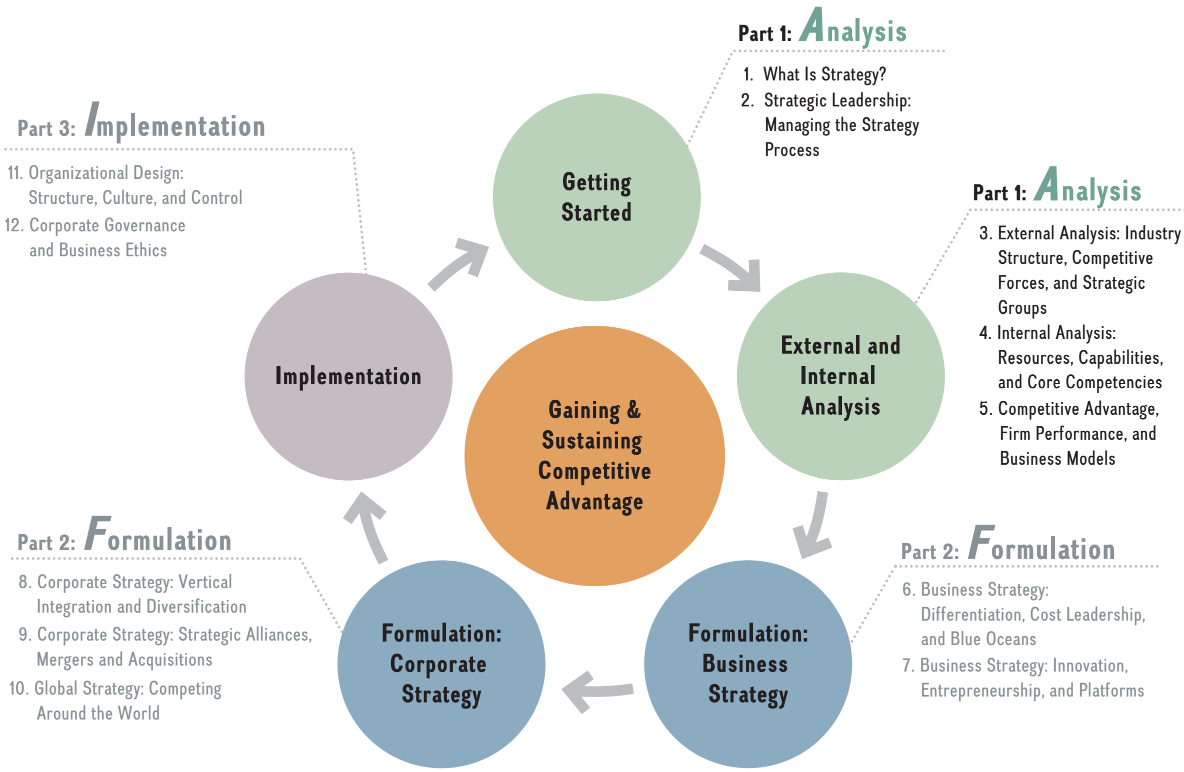
PART

1

Analysis

The AFI Strategy Framework



CHAPTER

1

What Is Strategy?

Chapter Outline

Learning Objectives

After studying this chapter, you should be able to:

LO 1-1 Explain the role of strategy in a firm's quest for competitive advantage.

LO 1-2 Define competitive advantage, sustainable competitive advantage, competitive disadvantage, and competitive parity.

LO 1-3 Assess the relationship between stakeholder strategy and sustainable competitive advantage.

LO 1-4 Conduct a stakeholder impact analysis.

LO 1-5 Explain the Analysis, Formulation, Implementation (AFI) Strategy Framework.

Tesla's Secret Strategy

TESLA INC., an American manufacturer of all-electric cars—boasted a market capitalization[1] of some $60 billion (in early 2019), an appreciation of more than 1,400 percent over its initial public offering price in 2010. How can a California startup achieve a market valuation that exceeds that of GM, one of the largest car manufacturers in the world, making some 10 million vehicles a year? The answer: Tesla's secret strategy. In a summer 2006 blog entry on Tesla's website, Elon Musk, Tesla's co-founder and CEO, explained the startup's master plan:[2]

1. Build sports car.
2. Use that money to build an affordable car.
3. Use *that* money to build an even more affordable car.
4. While doing above, also provide zero-emission electric power generation options.
5. Don't tell anyone.[2]

The Tesla Roadster 2 set new records for a vehicle to be driven on public roads: It goes from 0–60 mph in 1.9 seconds and from 0–100 mph in 4.2 seconds, with top speeds of well above 250 mph. The base price of this newest Tesla, scheduled to launch in 2020, is $200,000.

KYDPL KYODO/AP Images

Let's see if Tesla stuck to its strategy. In 2008, Tesla introduced its first car: the Roadster, a $110,000 sports coupe with faster acceleration than a Porsche or a Ferrari. Tesla's first vehicle served as a prototype to demonstrate that electric vehicles can be more than mere golf carts. Tesla thus successfully completed Step 1 of the master plan.

In Step 2, after selling some 2,500 Roadsters, Tesla discontinued its production in 2012 to focus on its next car: the Model S, a four-door family sedan, with an initial base price of $73,500. The line appeals to a somewhat larger market and thus allows for larger production runs to drive down unit costs. The Model S received an outstanding market reception. It was awarded not only the 2013 Motor Trend Car of the Year, but also received the highest score of any car ever tested by Consumer Reports (99/100). Tesla manufactures the Model S in the Fremont, California, factory that it purchased from Toyota. By the end of 2018, it had sold more than 250,000 of the Model S worldwide.

Hoping for an even broader customer appeal, Tesla also introduced the Model X, a crossover between an SUV and a family van with futuristic falcon-wing doors for convenient access to second- and third-row seating. The $100,000 starting sticker price of the Model X is quite steep, thus limiting its mass-market appeal. Technical difficulties with its innovative doors delayed its launch until the fall of 2015. By the end of 2018, however, Tesla had sold more than 100,000 of the Model X globally.

Tesla also completed Step 3 of its master plan. In 2016, the electric car maker unveiled the Model 3, an all-electric compact luxury sedan, with a starting price of $35,000. Many want-to-be Tesla owners stood in line overnight, eagerly waiting for Tesla stores to open so they could put down their $1,000 deposits to secure a spot on the waiting list for the Model 3—a car they had not even seen, let alone taken for a test drive. As a result of this consumer enthusiasm, Tesla received more than 500,000 preorders before the first delivery, and thus $500 million in interest-free loans. Despite initial difficulties in scaling up production, deliveries of the Model 3 began in the fall of 2017. By the end of 2018, Tesla had delivered more than 100,000 of the Model 3 globally. To meet the strong demand for the lower priced Model 3, Tesla hopes to increase its annual production to 1 million vehicles by 2020.

In the spring of 2019, Tesla launched the Model Y, a compact SUV that is a smaller and much lower priced version of the Model X. Elon Musk plans to start deliveries of the new Model Y between the fall of 2020 and spring 2021, with the entry version starting at $39,000 (and 230 miles range) and the high-end performance version starting at $60,000 (and 280 miles range).

Step 4 of Musk's master plan for Tesla aims to provide zero-emission electric power generation options. To achieve this goal, Tesla acquired SolarCity, a solar energy company, for more than $2 billion in the fall of 2016. This successful integration of Tesla and SolarCity, which resulted in the first fully integrated clean-tech energy company that combines solar power, power storage, and transportation, marks the completion of Step 4 in Tesla's master plan.

Step 5: "Don't tell anyone"—a humorous statement added by Elon Musk—thus the ChapterCase title "Tesla's Secret Strategy."[3]

NOTE: By summer 2019, Tesla's market cap stood at about $45 billion.

Part II of this ChapterCase appears in Section 1.4.

WHY IS TESLA SO SUCCESSFUL? In contrast to Tesla's success, the big-three U.S. automakers—Ford, GM, and Chrysler—struggled during the first decade of the 21st century, with both GM and Chrysler filing for bankruptcy protection.

If once-great firms can fail, why is any company successful? What enables some firms to gain and then sustain their competitive advantage over time? How can you as a strategic leader influence firm performance? These are the big questions that define strategic management. Answering these questions requires integrating the knowledge you've obtained in your studies of various business disciplines to understand what leads to superior performance, and how you can help your organization achieve it.

strategic management An integrative management field that combines analysis, formulation, and implementation in the quest for competitive advantage.

Strategic management is the integrative management field that combines *analysis, formulation,* and *implementation* in the quest for competitive advantage. Mastery of strategic management enables you to view an organization such as a firm or a nonprofit outfit in its entirety. It also enables you to think like a general manager to help position your organization for superior performance. The *AFI Strategy Framework* embodies this view of strategic management. It will guide our exploration of strategic management through the course of your study.

In this chapter, we lay the groundwork for the study of strategic management. We'll introduce foundational ideas about strategy and competitive advantage. We also move beyond an understanding of competitive advantage solely as superior financial performance, and introduce the concept of stakeholder strategy. This allows us to appreciate the role of business in society more broadly. Next, we take a closer look at the components of the AFI framework and provide an overview of the entire strategic management process. We conclude this introductory chapter, as we do with all others in this text, with a section titled *Implications for Strategic Leaders.* Here we provide practical applications and considerations of the material developed in the chapter. Let's begin the exciting journey to understand strategic management and competitive advantage.

LO 1-1

Explain the role of strategy in a firm's quest for competitive advantage.

1.1 What Strategy Is: Gaining and Sustaining Competitive Advantage

strategy The set of goal-directed actions a firm takes to gain and sustain superior performance relative to competitors.

Strategy is a set of goal-directed actions a firm takes to gain and sustain superior performance *relative* to competitors.[4] To achieve superior performance, companies compete for resources: New ventures compete for financial and human capital, existing companies compete for profitable growth, charities compete for donations, universities compete for the best students and professors, sports teams compete for championships, while celebrities compete for endorsements.

As highlighted in the ChapterCase, Tesla, a new entrant in the automotive industry, is competing for customers with established U.S. companies such as GM, Ford, and Chrysler and also with foreign automakers Toyota, Honda, Nissan, Hyundai, VW, Audi, Porsche, Mercedes, and BMW, among others. In any competitive situation, a **good strategy** enables a firm to achieve superior performance and sustainable competitive advantage relative to its competitors. A good strategy is based on a strategic management process that consists of three key elements:

1. A *diagnosis* of the competitive challenge. This element is accomplished through *analysis* of the firm's external and internal environments (Part 1 of the AFI framework).
2. A *guiding policy* to address the competitive challenge. This element is accomplished through strategy *formulation,* resulting in the firm's corporate, business, and functional strategies (Part 2 of the AFI framework).
3. A *set of coherent actions* to implement the firm's guiding policy. This element is accomplished through strategy *implementation* (Part 3 of the AFI framework).

good strategy Enables a firm to achieve superior performance and sustainable competitive advantage relative to its competitors. It is based on a strategic management process that consists of three elements: (1) a diagnosis of the competitive challenge; (2) a guiding policy to address the competitive challenge; and (3) a set of coherent actions to implement a firm's guiding policy.

CRAFTING A GOOD STRATEGY AT TESLA

Let's revisit ChapterCase 1 to see whether Tesla is pursuing a good strategy. Tesla appears to be performing quite well when considering indicators such as stock appreciation, where it outperforms its competitors. The appreciation of Tesla stock since its initial public offering (IPO) points to investors' expectations of future growth. By other measures, such as generating profits, Tesla underperforms compared to established car companies. Losses are common for startups early on, especially if the business requires large upfront investments such as building new and retooling existing factories, which Tesla was required to do. What we can say at this point is that Tesla seems to be starting with a promising strategy and is in the process of achieving superior performance relative to its competitors. But can Tesla sustain this superior performance over time? Let's use the three elements of good strategy to explore this question.

THE COMPETITIVE CHALLENGE. A good strategy needs to start with a clear and critical diagnosis of the competitive challenge. Musk, Tesla's co-founder and CEO, describes himself as an "engineer and entrepreneur who builds and operates companies to solve environmental, social, and economic challenges."[5] Tesla was founded with the vision to "accelerate the world's transition to sustainable transport."[6]

To accomplish this mission, Tesla must build zero-emission electric vehicles that are attractive and affordable. Beyond achieving a competitive advantage for Tesla, Musk is working to set a new standard in automotive technology. He hopes that zero-emission electric vehicles will one day replace gasoline-powered cars.

Tesla's competitive challenge is sizable: To succeed it must manufacture attractive and affordable vehicles using its new technology, which will compete with traditional cars running on gasoline. It also needs the required infrastructure for electric vehicles, including a network of charging stations to overcome "range anxiety"[7] by consumers; many mass-market electric vehicles cannot drive as far on one charge as gasoline-powered cars can with a full tank of gas. Gas stations can be found pretty much on any corner in cities and every couple of miles on highways.[8]

A GUIDING POLICY. After the diagnosis of the competitive challenge, the firm needs to formulate an effective guiding policy in response. The formulated strategy needs to be consistent, often backed up with *strategic commitments* such as sizable investments or changes to an organization's incentive and reward system—big changes that cannot be easily reversed. Without consistency in a firm's guiding policy, employees become confused and cannot make effective day-to-day decisions that support the overall strategy. Moreover, without consistency in strategy, other stakeholders, including investors, also become frustrated.

To address the competitive challenge, Tesla's current guiding policy is to build a cost-competitive mass-market vehicle such as the Model 3 (this is also Step 3 in Tesla's "Secret Strategy," as discussed in the ChapterCase). Tesla's formulated strategy is consistent with its mission and the competitive challenge identified. It also requires significant strategic commitments, as demonstrated by Tesla's $5 billion investment in a new lithium-ion battery plant in Nevada, the so-called Gigafactory. Batteries are the most critical component for electric vehicles, so to accomplish this major undertaking, Tesla partnered with Panasonic of Japan, a world leader in battery technology. To achieve its massive scale-up in Model 3 production, Tesla invested over $2 billion in a new manufacturing facility.

In 2019, Tesla followed up with another multibillion investment by breaking ground for a factory in Shanghai, China. This factory is huge, combining the size of the Tesla car manufacturing facility in Fremont, California, with its Gigafactory in Nevada. The goal is to produce batteries and cars not only at large scale, but also in the same location. This will help lower the price of the Model 3 further to service the Chinese market, which is already the largest electric vehicle market globally by a wide margin. Although such large, up-front investments frequently lead to early-year losses, they also represent strong and credible commitments to becoming a viable competitor in the mass automobile market.

COHERENT ACTIONS. A clear guiding policy needs to be implemented with a set of coherent actions. Tesla appears to implement its formulated strategy with actions consistent with its diagnosis of the competitive challenge. To accomplish building a cost-competitive mass-market vehicle, Tesla must benefit from *economies of scale,* which are decreases in cost per vehicle as output increases. To reap these critical cost reductions, Tesla must ramp up its production volume. This is a huge challenge: Tesla aims to increase its production output by some 20 times, from 50,000 cars built in 2015 to 1 million cars by 2020. Tesla's retooling of its manufacturing facility in Fremont, California, to rely more heavily on cutting-edge robotics as well as its multibillion-dollar investment to secure an uninterrupted supply of lithium-ion batteries exemplify actions coherent with Tesla's formulated strategy.

After production of the Model 3 began in mid-2017, major problems in operations limited the number of Model 3s produced to a mere 2,500 for the year. However, by the end of 2018, Tesla's huge investments in both its highly automated car manufacturing facility and in its battery plant started to pay off—production of the Model 3 increased to 1,000 units *a day*. Thus, Tesla plans to produce more than 350,000 Model 3s (by end of 2019), a number it needs to achieve if it is to sustain its cash flow and meet pent-up product demand. At the same time, Tesla is expanding its network of charging stations across North America, Europe, and China. To fund this initiative and to avoid bottlenecks, it announced it will no longer provide new Tesla owners free use of the company's charging network.

To accomplish the lofty goal of making zero-emission electric motors the new standard in automotive technology rather than internal combustion engines, Tesla decided to make some of its proprietary technology available to the public. Musk's hope is that sharing Tesla's patents will expand the overall market size for electric vehicles as other manufacturers can employ Tesla's technology.

In review, to craft a good strategy, three steps are crucial in the strategic management process: First, a good strategy defines the competitive challenges facing an organization through a critical and honest assessment of the status quo. Second, a good strategy provides an overarching approach on how to deal with the competitive challenges identified. The approach needs to be communicated in policies that provide clear guidance for employees. Last, a good strategy requires effective implementation through a coherent set of actions. Strategy Highlight 1.1 takes a closer look at Twitter, and asks whether the social media news service has a strategy.

Strategy Highlight **1.1**

Does Twitter Have a Strategy?

Twitter is not flying high! Shortly after its successful initial public offering in 2014, its market capitalization[9] has fallen by 50 percent—from $40 billion to $20 billion in late 2018. Twitter's user growth has stagnated, while core Tweeters are tweeting less and less. In 2015, co-founder Jack Dorsey returned as CEO but could not reverse Twitter's decline. In comparison, during the same time period, Facebook's market cap quadrupled from some $100 billion to $400 billion. The question thus arises: Does Twitter have a strategy?

Launched in 2006, Twitter is an online news and social networking site that allows its Tweeters to send short messages ("tweets") of up to 280 characters or less (and can include images or videos) to all followers. People who follow each other on Twitter can see each others' status updates in their feeds. Users with the most followers include Katy Perry, American singer-songwriter and actress, with more than 107 million; Justin Bieber, Canadian singer-songwriter, with 105 million; and former President Barack Obama with 104 million.

While popular for its scannable content, Twitter's social significance resulted from its pivotal role during the Arab Spring (2010–2012), in the Black Lives Matter movement (founded in 2013), and for its real-time coverage of such breaking news as the raid on Osama bin Laden's compound in Pakistan (2011). Many of the most powerful politicians in the world such as President Donald Trump and India Prime Minister Narendra Modi use Twitter to communicate directly with the public, allowing them to bypass traditional media outlets.

To answer the question of whether Twitter has a strategy, let's apply the three critical elements of a good strategy and the three critical tasks of a good strategic management process: *diagnose the competitive challenge, derive a guiding policy,* and *implement a coherent set of actions.*

THE COMPETITIVE CHALLENGE Twitter's business model is to grow its user base and then charge advertisers for promoting goods and services to that user base. While individual users pay nothing, their tweets give Twitter free user-generated content to drive more traffic to its site. Companies pay for "promoted tweets" that are directly inserted into a user's news stream. But compare Twitter's 330 million monthly users to Facebook's over 2 billion users—this tells us that Facebook's user base is almost seven times the size of Twitter's. Given its much smaller user base, advertisers view Twitter as a niche application and thus will direct the bulk of their digital ad dollars to larger sites such as Facebook, Google, and Amazon.

Twitter is not flying high! Between 2014 and 2018, it lost $20 billion in market capitalization.
x9626/Shutterstock

Compared to Facebook, Twitter suffers in ways other than sheer scale. For instance, it has allowed competitors such as Snapchat, WhatsApp, and Instagram (all owned by Facebook) to move into the space it originally created. In addition, Facebook allows advertisers to target their online ads more precisely by using the demographic data Facebook collects, including birth year, university affiliation, network of friends, interests, and so forth. (This data collection has created a whole different set of problems for Facebook, which is discussed further in ChapterCase 2). Clearly, Twitter needs a larger user base to attract more online advertisers and better monetize its social media service.

A GUIDING POLICY Here is where Twitter's problems begin. While its leaders have accurately identified and diagnosed Twitter's competitive challenge (to grow its user base), they still lack a clear guiding policy for how to address this challenge. One way would be to simplify the sign-up process. Another would be to better explain the sometimes idiosyncratic conventions of Twitter use to a broader audience. Yet another would be to root out offensive content, fake accounts, and misinformation, and to be more aggressive about blocking cyber trolls. Perhaps even more important, Twitter needs to find a way to take

(*Continued*)

back the social media space that's now being dominated by Snapchat, WhatsApp, and Instagram.

COHERENT ACTIONS Changing the goalpost of which users (core, noncore, or passive viewers that see tweets on other media) to target not only confused management, but it also limited functional guidance for employees in day-to-day operations. Consequences of confusing directions for strategy implementation followed, including increased frustration among managers and engineers, which led to the turnover of key personnel. As Twitter attempts to be more attractive to different types of users, it encounters trade-offs that are hard if not impossible to reconcile. Consider the search or mobile functionality of an application, for example: The needs of core users are very different from that of casual visitors or passive viewers. Internal turmoil was further stoked by several management demotions as well as promotions of close personal friends of the CEO. From its inception, Twitter's culture has been hampered by infighting and public intrigues among co-founders and other early leaders.

To reduce the gap with Facebook's enormous scale and global reach, Twitter has attempted to be everything to everybody, without considering the strategic trade-offs. This has resulted in not only low employee morale, but also inferior performance. Declaring that Twitter's "ambition is to have the largest audience in the world"[10] is not a good strategy; it is no strategy at all. Rather it is a mere statement of desire. With Twitter's continuing decline in its market cap, it is likely to end up a takeover target.[11]

LO 1-2

Define competitive advantage, sustainable competitive advantage, competitive disadvantage, and competitive parity.

WHAT IS COMPETITIVE ADVANTAGE?

A firm that achieves superior performance relative to other competitors in the same industry or the industry average has a **competitive advantage**.[12] Competitive advantage is always *relative,* not absolute. To assess competitive advantage, we compare firm performance to a *benchmark*—that is, either the performance of other firms in the same industry or an industry average. In terms of stock market valuation, Tesla has appreciated much more in recent years than GM, Ford, or Chrysler, and thus appears to have a competitive advantage, at least on this dimension.

A firm that is able to outperform its competitors or the industry average over a prolonged period has a **sustainable competitive advantage**. Apple, for example, has enjoyed a sustainable competitive advantage over Samsung in the smartphone industry for over a decade since its introduction of the iPhone in 2007. Other phone makers such as Microsoft (which purchased Nokia) and BlackBerry have all but exited the smartphone market, while new entrants such as Huawei and Xiaomi of China are trying to gain traction.

If a firm underperforms its rivals or the industry average, it has a **competitive disadvantage**. For example, a 15 percent return on invested capital may sound like superior firm performance. In the consulting industry, though, where the average return on invested capital is often above 20 percent, such a return puts a firm at a competitive disadvantage. In contrast, if a firm's return on invested capital is 2 percent in a declining industry, like newspaper publishing, where the industry average has been negative (–5 percent) for the past few years, then the firm has a competitive advantage. Should two or more firms perform at the same level, they have **competitive parity**. In Chapter 5, we'll discuss in greater depth how to evaluate and assess competitive advantage and firm performance.

To gain a competitive advantage, a firm needs to provide either goods or services consumers value more highly than those of its competitors, or goods or services similar to the competitors' at lower cost. The rewards of superior value creation and capture are profitability and market share. Elon Musk is particularly motivated to address

competitive advantage Superior performance relative to other competitors in the same industry or the industry average.

sustainable competitive advantage Outperforming competitors or the industry average over a prolonged period of time.

competitive disadvantage Underperformance relative to other competitors in the same industry or the industry average.

competitive parity Performance of two or more firms at the same level.

global warming, and thus formed Tesla to build electric vehicles with zero emissions. Sara Blakely, the founder and CEO of Spanx, the global leader in the shapewear industry, is motivated to change women's lives. Sam Walton was driven by offering acceptable value at lower cost than his competitors when creating Walmart, the world's largest (brick-and-mortar) retailer. For Musk, Blakely, Walton, and numerous other entrepreneurs and businesspeople, creating shareholder value and making money is the *consequence* of filling a need and providing a product, service, or experience consumers wanted, at a price they could afford while still making a profit.

Spanx founder and CEO Sara Blakely, a graduate of Florida State University and former salesperson of fax machines, was America's richest self-made woman in 2018, according to *Forbes*.
Marla Aufmuth/Getty Images

The important point here is that strategy is about delivering superior value, while containing the cost to create it, or by offering similar value at lower cost. Managers achieve these combinations of value and cost through *strategic positioning.* That is, they stake out a unique position within an industry that allows the firm to provide value to customers, while controlling costs. The greater the difference between value creation and cost, the greater the firm's *economic contribution* and the more likely it will gain competitive advantage.

Strategic positioning requires *trade-offs,* however. As a low-cost retailer, Walmart has a clear strategic profile and serves a specific market segment. Upscale retailer Nordstrom has also built a clear strategic profile by providing superior customer service to a higher end, luxury market segment. Although these companies are in the same industry, their customer segments overlap very little, and they are not direct competitors. Walmart and Nordstrom have each chosen a distinct but different strategic position. The managers make conscious trade-offs that enable each company to strive for competitive advantage in the retail industry, using different competitive strategies: cost leadership versus differentiation. In regard to the customer service dimension, Walmart provides acceptable service by low-skill employees in a big-box retail outlet offering "everyday low prices," while Nordstrom provides a superior customer experience by professional salespeople in a luxury setting.

A clear strategic profile—in terms of product differentiation, cost, and customer service—allows each retailer to meet specific customer needs. Competition focuses on creating value for customers (through lower prices or better service and selection, in this example) rather than destroying rivals. Even though Walmart and Nordstrom compete in the same industry, both can win if they achieve a clear strategic position through a well-executed competitive strategy. Strategy, therefore, is not a zero-sum game.

The key to successful strategy is to combine a set of activities to stake out a *unique strategic position* within an industry. Competitive advantage has to come from performing different activities or performing the same activities differently than rivals are doing. Ideally, these activities reinforce one another rather than create trade-offs. For instance, Walmart's strategic activities strengthen its position as cost leader: Big retail stores in rural locations, extremely high purchasing power, sophisticated IT systems, regional distribution centers, low corporate overhead, and low base wages and salaries combined with employee profit sharing reinforce each other, to maintain the company's cost leadership.

Since clear strategic positioning requires trade-offs, strategy is as much about deciding what *not* to do, as it is about deciding what to do.[13] Because resources are limited, managers must carefully consider their strategic choices in the quest for competitive advantage. Trying to be everything to everybody will likely result in inferior performance.

As a striking example, the department store chain Sears was founded in 1886 and long hailed as an innovator. Sears pioneered its iconic mail-order catalog shortly after its founding, which allowed customers in rural and remote areas of the United States to shop like city dwellers (a similar service to what Amazon provides today, albeit relying on a much smaller selection and slower deliveries). Yet, as time progressed and Sears failed to adapt to new competitive challenges, it lost its competitive advantage. More recently, Sears did not have a clear strategic position but tried to be too many things for too many types of customers. As a consequence, after more than 130 years in business, Sears filed for bankruptcy in 2018.

It is also important to note that operational effectiveness, marketing skills, and other functional expertise all strengthen a unique strategic position. Those capabilities, though, do not substitute for competitive strategy. Competing to be similar but just a bit better than your competitor is likely to be a recipe for cut-throat competition and low profit potential. Let's take this idea to its extreme in a quick thought experiment: If all firms in the same industry pursued a low-cost position through application of competitive benchmarking, all firms would have identical cost structures. None could gain a competitive advantage. Everyone would be running faster, but nothing would change in terms of relative strategic positions. There would be little if any value creation for customers because companies would have no resources to invest in product and process improvements. Moreover, the least-efficient firms would be driven out, further reducing customer choice.

To gain a deeper understanding of what strategy is, it may be helpful to think about what strategy is *not*.[14] Be on the lookout for the following major hallmarks of what strategy is *not*:

GRANDIOSE STATEMENTS ARE NOT STRATEGY. You may have heard firms say things like, "Our strategy is to win" or "We will be No. 1." Twitter, for example, declared its "ambition is to have the largest audience in the world."[15] Such statements of desire, on their own, are not strategy. They provide little managerial guidance and often lead to goal conflict and confusion. Moreover, such wishful thinking frequently fails to address economic fundamentals. As we will discuss in the next section, an effective vision and mission *can* lay the foundation upon which to craft a good strategy. This foundation must be backed up, however, by strategic actions that allow the firm to address a competitive challenge with clear consideration of economic fundamentals, in particular, value creation and costs.

A FAILURE TO FACE A COMPETITIVE CHALLENGE IS NOT STRATEGY. If a firm does not define a clear competitive challenge, employees have no way of assessing whether they are making progress in addressing it. Strategic leaders at the now-defunct video rental chain Blockbuster, for example, failed to address the competitive challenges posed by new players Netflix, Redbox, Amazon Prime, and Hulu.

OPERATIONAL EFFECTIVENESS, COMPETITIVE BENCHMARKING, OR OTHER TACTICAL TOOLS ARE NOT STRATEGY. People casually refer to a host of different policies and initiatives as some sort of strategy: pricing strategy, internet strategy, alliance strategy, operations strategy, IT strategy, brand strategy, marketing strategy, HR strategy, China strategy, and so on. All these elements may be a *necessary* part of a firm's functional and global initiatives to support its competitive strategy, but these elements are *not sufficient* to achieve competitive advantage. In this text, we will reserve the term *strategy* for describing the firm's overall efforts to *gain and sustain competitive advantage.*

1.2 Stakeholder Strategy and Competitive Advantage

LO 1-3

Assess the relationship between stakeholder strategy and sustainable competitive advantage.

VALUE CREATION

Companies with a good strategy generate value for society. When firms compete in their own self-interest while obeying the law and acting ethically, they ultimately create value. **Value creation** occurs because companies with a good strategy are able to provide products or services to consumers at a price point that they can afford while keeping their costs in check, thus making a profit at the same time. Both parties benefit from this trade as each captures a part of the value created. In so doing, they leave society better off.[16]

value creation Occurs when companies with a good strategy are able to provide products or services to consumers at a price point that they can afford while keeping their costs in check, thus making a profit at the same time. Both parties benefit from this trade as each captures a part of the value created.

Value creation in turn lays the foundation for the benefits that successful economies can provide: education, infrastructure, public safety, health care, clean water and air, among others. Superior performance allows a firm to reinvest some of its profits and to grow, which in turn provides more opportunities for employment and fulfilling careers. Although Google (a division of Alphabet) started as a research project in graduate school by Larry Page and Sergey Brin in the late 1990s, some 20 years later it had become one of the most valuable companies in the world with over $800 billion in market capitalization and 100,000 employees, not to mention the billions of people across the world who rely on it for information gathering and decision making, which is free for the end user.[17]

Strategic failure, in contrast, can be expensive. Once a leading technology company, Hewlett-Packard was known for innovation, resulting in superior products. The "HP way of management" included lifetime employment, generous benefits, work/life balance, and freedom to explore ideas, among other perks.[18] However, HP has not been able to address the competitive challenges of mobile computing or business IT services effectively. As a result, HP's stakeholders suffered. Shareholder value was destroyed. The company also had to lay off tens of thousands of employees. Its customers no longer received the innovative products and services that made HP famous.

The contrasting examples of Alphabet and HP illustrate the relationship between individual firms, competitive advantage, and society at large. Successful firms ultimately create value for society. In the first decade of the new millennium, this relationship received more critical scrutiny due to major shocks to free market capitalism.[19] In particular, the implicit trust relationship between the corporate world and society at large has deteriorated because of several notable crises. One of the first crises of the 21st century occurred when the accounting scandals at Enron, Arthur Andersen, WorldCom, Tyco, Adelphia, and others, came to light. Those events led to bankruptcies, large-scale job loss, and the destruction of billions of dollars in shareholder value. As a result, the public's trust in business and free market capitalism began to erode.

Another major event occurred in the fall of 2008 with the global financial crisis, which shook the entire free market system to its core.[20] A real estate bubble had developed in the United States, fueled by cheap credit and the availability of subprime mortgages. When that bubble burst, many entities faced financial duress or bankruptcy—those who had unsustainable mortgages, investors holding securities based on those mortgages, and the financial institutions that had sold the securities. Some went under, and others were sold at fire-sale prices. Home foreclosures skyrocketed as a large number of borrowers defaulted on their mortgages. House prices in the United States plummeted by roughly 30 percent. The United States plunged into a deep recession. In the process, the Dow Jones Industrial Average (DJIA) lost about half its market value.

The impact was worldwide. The freezing of capital markets during the global financial crisis triggered a debt crisis in Europe. Some European governments (notably Greece) defaulted on government debt; other countries were able to repay their debts only through the assistance of other, more solvent European countries. This severe financial crisis not only put Europe's common currency, the euro, at risk, but also led to a prolonged and deep recession in Europe. Disenchanted with the European Union, the United Kingdom voted in 2016 to leave the alliance in wake of the Brexit movement (short for British exit). In the United States, the Occupy Wall Street protest movement was born out of dissatisfaction with the capitalist system. Issues of income disparity, corporate ethics, corporate influence on governments, and ecological sustainability were key drivers.

Although these major events in the business world differed in their specifics, two common features are pertinent to our study of strategic management.[21] First, these events demonstrate that managerial actions can affect the economic well-being of large numbers of people around the globe. Most of the events resulted from executive actions within a few organizations, or compounded across a specific industry or government. The second pertinent feature relates to **stakeholders**—organizations, groups, and individuals that can affect or be affected by a firm's actions.[22] This leads us to *stakeholder strategy,* which we discuss next.

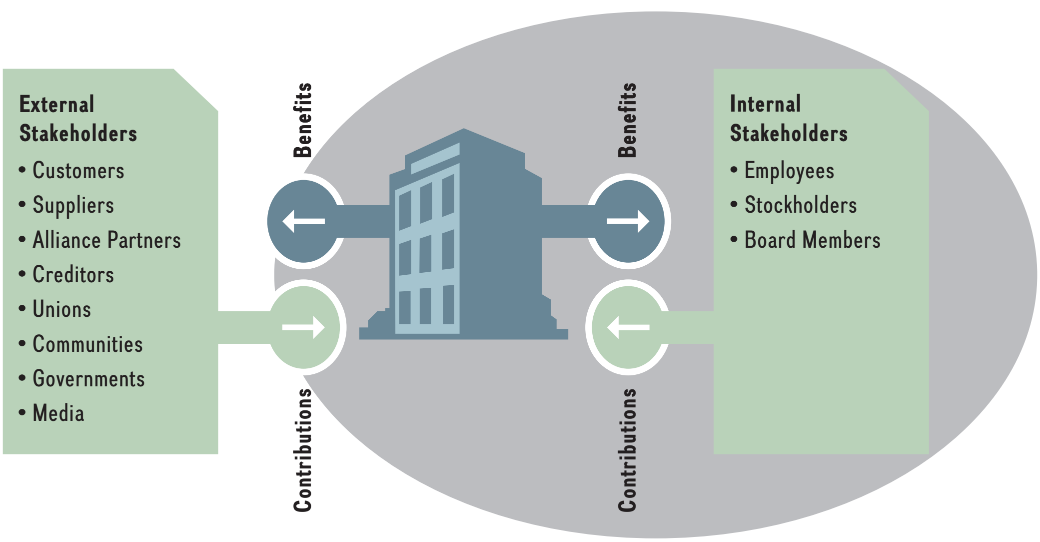
stakeholders Organizations, groups, and individuals that can affect or are affected by a firm's actions.

STAKEHOLDER STRATEGY

Stakeholders have a vested claim or interest in the performance and continued survival of the firm. Stakeholders can be grouped by whether they are internal or external to a firm. As shown in Exhibit 1.1, *internal stakeholders* include employees (executives, managers, and workers), stockholders, and board members. *External stakeholders* include customers, suppliers, alliance partners, creditors, unions, communities, governments at various levels, and the media.

All stakeholders make specific contributions to a firm, which in turn provides different types of benefits to different stakeholders. Employees contribute their time and talents to the firm, receiving wages and salaries in exchange. Shareholders contribute capital with the expectation that the stock will rise and the firm will pay dividends. Communities provide real estate, infrastructure, and public safety. In return, they expect that companies will pay

EXHIBIT 1.1 Internal and External Stakeholders in an Exchange Relationship with the Firm



taxes, provide employment, and not pollute the environment. The firm, therefore, is embedded in a multifaceted *exchange relationship* with a number of diverse internal and external stakeholders. If any stakeholder withholds participation in the firm's exchange relationships, it can negatively affect firm performance. The aerospace company Boeing, for example, has a long history of acrimonious labor relations, leading to walk-outs and strikes. This in turn has not only delayed production of airplanes but also raised costs.

stakeholder strategy An integrative approach to managing a diverse set of stakeholders effectively in order to gain and sustain competitive advantage.

Stakeholder strategy is an integrative approach to managing a diverse set of stakeholders effectively in order to gain and sustain competitive advantage.[23] The unit of analysis is the web of exchange relationships a firm has with its stakeholders (see Exhibit 1.1). Stakeholder strategy allows firms to analyze and manage how various external and internal stakeholders interact to jointly create and trade value.[24] A core tenet of stakeholder strategy is that a single-minded focus on shareholders alone exposes a firm to undue risks. Simply putting shareholder interest above all else can undermine economic performance and even threaten the very survival of the enterprise. A strategic leader, therefore, must understand the complex web of exchange relationships among different stakeholders. With that understanding, the firm can proactively shape the various relationships to maximize the joint value created and manage the distribution of this larger pie in a fair and transparent manner. Effective stakeholder management exemplifies how strategic leaders can act to improve firm performance, thereby enhancing the firm's competitive advantage and the likelihood of its continued survival.[25]

Taken together, strategy scholars have provided several arguments as to why effective stakeholder management can benefit firm performance:[26]

- Satisfied stakeholders are more cooperative and thus more likely to reveal information that can further increase the firm's value creation or lower its costs.
- Increased trust lowers the costs for firms' business transactions.
- Effective management of the complex web of stakeholders can lead to greater organizational adaptability and flexibility.
- The likelihood of negative outcomes can be reduced, creating more predictable and stable returns.
- Firms can build strong reputations that are rewarded in the marketplace by business partners, employees, and customers. Most managers do care about public perception of the firm and frequently celebrate and publicize high-profile rankings such as the "World's Most Admired Companies" published annually by *Fortune.*[27] In 2018, the top five companies in this ranking were Apple, Amazon, Alphabet, Berkshire Hathaway (the conglomerate led by Warren Buffett), and Starbucks. Because of its continued innovation in products, services, and delivery, Apple has been ranked as the world's most admired company for the past several years by *Fortune.*

LO 1-4

Conduct a stakeholder impact analysis.

STAKEHOLDER IMPACT ANALYSIS

stakeholder impact analysis A decision tool with which managers can recognize, prioritize, and address the needs of different stakeholders, enabling the firm to achieve competitive advantage while acting as a good corporate citizen.

The key challenge of stakeholder strategy is to effectively balance the needs of various stakeholders. The firm needs to ensure that its primary stakeholders—the firm's shareholders and other investors—achieve their objectives. At the same time, the firm needs to recognize and address the concerns of other stakeholders—employees, suppliers, and customers—in an ethical and fair manner, so that they too are satisfied. This all sounds good in theory, but how can strategic leaders go about this in practice?

Stakeholder impact analysis provides a decision tool with which strategic leaders can recognize, prioritize, and address the needs of different stakeholders. This tool helps the firm achieve a competitive advantage while acting as a good corporate citizen. Stakeholder impact analysis takes strategic leaders through a five-step process of recognizing stakeholders' claims. In each step, they must pay particular attention to three important stakeholder attributes: *power, legitimacy,* and *urgency.*[28]

- A stakeholder has *power* over a company when it can get the company to do something that it would not otherwise do.
- A stakeholder has a *legitimate claim* when it is perceived to be legally valid or otherwise appropriate.
- A stakeholder has an *urgent claim* when it requires a company's immediate attention and response.

Exhibit 1.2 depicts the five steps in stakeholder impact analysis and the key questions to be asked. Let's look at each step in detail.

STEP 1: IDENTIFY STAKEHOLDERS. In Step 1, strategic leaders ask, "Who are our stakeholders?" In this step, the strategic leaders focus on stakeholders that currently have, or potentially can have, a material effect on a company. This prioritization identifies the most powerful internal and external stakeholders as well as their needs. For public-stock companies, key stakeholders are the shareholders and other providers of capital. If shareholders are not satisfied with returns to investment, they will sell the company's stock, leading to a fall in the firm's market value. If this process continues, it can make the company a takeover target, or launch a vicious cycle of continued decline.

A second group of stakeholders includes customers, suppliers, and unions. Local communities and the media are also powerful stakeholders that can affect the smooth operation of the firm. Any of these groups, if their needs are not met, can materially affect the company's operations.

For example, Boeing opened an airplane factory in South Carolina to move production away from its traditional plant near Seattle, Washington. South Carolina is one of 28 states in the United States that operates under a right-to-work law in which employees in unionized workplaces are allowed to work without being required to join the union. In contrast to its work force in Washington state, the South Carolina plant is nonunionized, which should

EXHIBIT 1.2 Stakeholder Impact Analysis

lead to fewer work interruptions due to strikes and Boeing hopes to higher productivity and improvements along other performance dimensions (like on-time delivery of new airplanes). Boeing decided to build its new 787 Dreamliner jet exclusively in its nonunionized South Carolina factory.[29]

STEP 2: IDENTIFY STAKEHOLDERS' INTERESTS. In Step 2, strategic leaders ask, "What are our stakeholders' interests and claims?" They need to specify and assess the interests and claims of the pertinent stakeholders using the power, legitimacy, and urgency criteria introduced earlier. As the legal owners, shareholders have the most legitimate claim on a company's profits. However, the wall separating the claims of ownership (by shareholders) and of management (by employees) has been eroding. Many companies incentivize top executives by paying part of their overall compensation with stock options. They also turn employees into shareholders through *employee stock ownership plans (ESOPs).* These plans allow employees to purchase stock at a discounted rate or use company stock as an investment vehicle for retirement savings. For example, Alphabet, Coca-Cola, Facebook, Microsoft, Southwest Airlines, Starbucks, and Walmart all offer ESOPs. Clearly, the claims and interests of stakeholders who are employed by the company, and who depend on the company for salary and other benefits, will be somewhat different from those of stakeholders who merely own stock. The latter are investors who are primarily interested in the increased value of their stock holdings through appreciation and dividend payments. Executives, managers, and workers tend to be more interested in career opportunities, job security, employer-provided health care, paid vacation time, and other perks.

Even within stakeholder groups there can be significant variation in the power a stakeholder may exert on the firm. For example, public companies pay much more attention to large investors than to the millions of smaller, individual investors. *Shareholder activists,* such as Bill Ackman, Carl Icahn, or Daniel Loeb, tend to buy equity stakes in a corporation that they believe is underperforming to put public pressure on a company to change its strategy. Examples include the takeover battle at Dell Computer (which founder Michael Dell subsequently took private, before going public again a few years later), the pressure on PepsiCo to spin off its Frito-Lay brand, or on Yahoo to sell itself to Verizon, which it did. Even top-performing companies are not immune to pressure by shareholder activists.[30] As a result of a sustained competitive advantage over the last decade, Apple had not only become the first company to be valued above $1 trillion but also amassed some $200 billion in cash in the process. Apple CEO Tim Cook faced significant pressure from Carl Icahn, who held roughly $4 billion worth of Apple stock, to buy back more of its shares and thus to further raise Apple's share price. Cook obliged, and Apple bought back a significant amount of stock, using its cash to buttress its share price.

Although both individual and activist investors may claim the same legitimacy as stockholders, shareholder activists have much more power over a firm. They can buy and sell a large number of shares at once or exercise block-voting rights in the *corporate governance process* (which we'll discuss in detail in Chapter 12). Shareholder activists frequently also demand seats on the company's board to more directly influence its corporate governance, and with it exert more pressure to change a company's strategy. These abilities make activist investors powerful stakeholders, with urgent and legitimate claims.

STEP 3: IDENTIFY OPPORTUNITIES AND THREATS. In Step 3, strategic leaders ask, "What opportunities and threats do our stakeholders present?" Since stakeholders have a claim on the company, opportunities and threats are two sides of the same coin. Consumer boycotts, for example, can be a credible threat to a company's behavior. Some consumers boycotted BP for its role in the 2010 Gulf of Mexico oil spill and resulting environmental damages; Nestlé products were boycotted when the firm promoted infant formula over breast milk in developing countries. PETA[31] called for a boycott of McDonald's due to alleged animal-rights abuses.

In the best-case scenario, managers transform such threats into opportunities. Sony Corp. of Japan, for example, was able to do just that.[32] During one holiday season, the Dutch government blocked Sony's entire holiday season shipment of PlayStation game systems, valued at roughly $500 million, into the European Union because of a small but legally unacceptable amount of toxic cadmium discovered in one of the system's cables. This incident led to an 18-month investigation in which Sony inspected over 6,000 supplier factories around the world to track down the source of the problem. The findings allowed Sony to redesign and develop a cutting-edge supplier management system that now adheres to a stringent extended value chain responsibility.

STEP 4: IDENTIFY SOCIAL RESPONSIBILITIES. In Step 4, strategic leaders ask, "What economic, legal, ethical, and philanthropic responsibilities do we have to our stakeholders?" To identify these responsibilities more effectively, scholars have advanced the notion of **corporate social responsibility (CSR).** This framework helps firms recognize and address the economic, legal, ethical, and philanthropic expectations that society has of the business enterprise at a given point in time.[33] According to the CSR perspective, strategic leaders need to realize that society grants shareholders the right and privilege to create a publicly traded stock company. Therefore, the firm owes something to society.[34] CSR provides strategic leaders with a conceptual model that more completely describes a society's expectations and can guide strategic decision making more effectively. In particular, CSR has four components:

corporate social responsibility (CSR)
A framework that helps firms recognize and address the economic, legal, social, and philanthropic expectations that society has of the business enterprise at a given point in time.

- Economic responsibilities
- Legal responsibilities
- Ethical responsibilities
- Philanthropic responsibilities[35]

Economic Responsibilities. The business enterprise is first and foremost an economic institution. Investors expect an adequate return for their risk capital. Creditors expect the firm to repay its debts. Consumers expect safe products and services at appropriate prices and quality. Suppliers expect to be paid in full and on time. Governments expect the firm to pay taxes and to manage natural resources such as air and water under a decent stewardship. To accomplish all this, firms must obey the law and act ethically in their quest to gain and sustain competitive advantage.

Nobel laureate Milton Friedman views the economic responsibility of the firm as its primary objective, as captured in his famous quote: "There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."[36]

Legal Responsibilities. Laws and regulations are a society's codified ethics, embodying notions of right and wrong. They also establish the rules of the game. For example, business as an institution can function because property rights exist and contracts can be enforced in courts of law. Strategic leaders must ensure that their firms obey all the laws and regulations, including but not limited to labor, consumer protection, and environmental laws.

One far-reaching piece of U.S. legislation in terms of business impact, for example, is the Patient Protection and Affordable Care Act (PPACA), more commonly known as the

Affordable Care Act (ACA) or Obamacare. Key provisions of this federal law include, among others, that firms with 50 or more full-time employees must offer affordable health insurance to their employees and dependents, or pay a fine for each worker. This makes it harder for entrepreneurs to grow their ventures above this threshold. One reaction of many small businesses has been to reduce the number of full-time workers to 49 employees and add part-time employees only, which do not fall under this provision. Another reaction of employers is to offer lower wages to compensate for higher health care costs. Moreover, health insurance providers are no longer allowed to deny coverage based on preexisting medical conditions. As a consequence, health care premiums have been rising as the overall risk pool of insurers is less healthy.[37]

Ethical Responsibilities. Legal responsibilities, however, often define only the minimum acceptable standards of firm behavior. Frequently, strategic leaders are called upon to go beyond what is required by law. The letter of the law cannot address or anticipate all possible business situations and newly emerging concerns such as internet privacy or advances in artificial intelligence, DNA testing, genetic engineering, and stem-cell research. A firm's ethical responsibilities, therefore, go beyond its legal responsibilities. They embody the full scope of expectations, norms, and values of its stakeholders. Strategic leaders are called upon to do what society deems just and fair.

In the spring of 2018, Starbucks received harsh criticism from multiple stakeholders.[38] Calls to #BoycottStarbucks went viral on social media. What caused the firestorm? Two African-American men were arrested at one of its Philadelphia locations. Reports indicated that the two men had entered the Starbucks store and asked one of the employees to use the restroom. The employee refused permission because the men had not (yet) purchased anything. They proceeded to sit down, stating they were meeting an associate for a business meeting and that they would order upon his arrival. Shortly thereafter the two men were asked to leave the store. The store manager eventually called the police who arrested them for alleged trespassing. A patron videotaped the entire scene and then posted it to Twitter; it has since been viewed more than 11 million times and retweeted more than 150,000 times. In the video, we see police officers handcuffing the two men while a perplexed and upset bystander repeatedly asks the police, "But what did they do? What did they do? Someone tell me what they did."[39]

In response to the public outcry over the store's actions and the grave concerns expressed by stakeholders, Starbucks CEO Kevin Johnson issued a formal apology in which he expressed regret over the situation's "reprehensible outcome" and stated that the actions of the employees were "not representative of ... Starbucks' mission and values."[40] A few weeks after the incident, Starbucks, at a significant cost, closed its more than 8,000 stores across the United States for a full day and dedicated the day to racial bias and diversity training for all employees. This was not an action the firm was legally required to do, but one it felt ethically obligated to do to avoid a repeat of such incidents.[41]

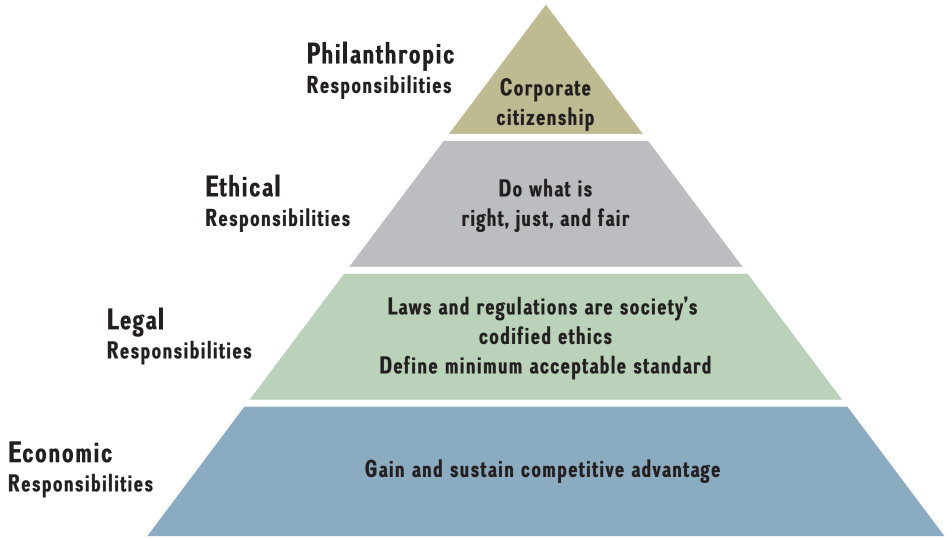
Philanthropic Responsibilities. Philanthropic responsibilities are often subsumed under the idea of *corporate citizenship,* reflecting the notion of voluntarily giving back to society. Over the years, Microsoft's corporate philanthropy program has donated more than $3 billion in cash and software to people who can't afford computer technology.[42]

The pyramid in Exhibit 1.3 summarizes the four components of corporate social responsibility.[43] Economic responsibilities are the foundational building block, followed by legal, ethical, and philanthropic responsibilities. Note that society and shareholders *require* economic and legal responsibilities. Ethical and philanthropic responsibilities result from a society's expectations toward business. The pyramid symbolizes the need for firms to

EXHIBIT 1.3

The Pyramid of Corporate Social Responsibility

Adapted from A. B. (Carroll, 1991, July–August), "The pyramid of corporate social responsibility: Toward the moral management of organizational stakeholders," *Business Horizons*: 42.



carefully balance their social responsibilities. Doing so ensures not only effective strategy implementation, but also long-term viability.

STEP 5: ADDRESS STAKEHOLDER CONCERNS. Finally, in Step 5, the firm asks, "What should we do to effectively address any stakeholder concerns?" In the last step in stakeholder impact analysis, strategic leaders need to decide the appropriate course of action for the firm, given all of the preceding factors. Thinking about the attributes of power, legitimacy, and urgency helps to prioritize the legitimate claims and to address them accordingly.

Strategy Highlight 1.2 describes Merck's stakeholder strategy anchored in ethical core values. It showcases how Merck considered and addressed various claims from a wide variety of stakeholders, among them the most disadvantaged patients that can't afford to pay for medications.

Strategy Highlight 1.2

Merck's Stakeholder Strategy

Merck's vision is to *preserve and improve human life*. The words of founder George W. Merck still form the basis of the company's values today: *We try to never forget that medicine is for the people. It is not for profits. The profits follow, and if we have remembered that, they have never failed to appear*.[44]

ENDING RIVER BLINDNESS Ray Vagelos, a former Merck scientist turned CEO, announced (in 1987) that the company would donate its recently discovered drug Mectizan, without charge, to treat river blindness. For centuries, river blindness—a parasitic disease that leads to loss of eyesight—plagued remote communities in Africa and other parts of the world. Merck's executives formed a novel private-public partnership, the Mectizan Donation Program (MDP), to distribute the drug in remote areas, where health services are often not available.

After more than 25 years, more than 1 billion treatments, and some 120,000 communities served, the disease had effectively been eradicated. Merck's current CEO, Kenneth Frazier, announced himself "humbled" by the result of the company's value-driven actions.[45]

WITHDRAWING VIOXX In the case of another drug, though, Merck's stakeholder strategy was questioned. Vioxx was a painkiller developed to produce fewer gastrointestinal side effects than aspirin or ibuprofen. Once the Food and Drug Administration (FDA) approved the new drug in 1999, Merck engaged in typical big pharma promotional practices:

- Heavy direct-to-consumer advertising via TV and other media.
- Luxury doctor inducements, including consulting contracts and free retreats at exotic resorts.

Merck's new drug was a blockbuster, generating revenues of $2.5 billion a year by 2002 and growing fast.

Kenneth Frazier, CEO of Merck.
Stephanie Keith/Getty Images

Allegations began to appear, however, that Vioxx caused heart attacks and strokes. Critics alleged that Merck had suppressed evidence about Vioxx's dangerous side effects from early clinical trials. In 2004, Merck voluntarily recalled the drug. Merck's CEO at the time, Raymond Gilmartin, framed the situation in terms of knowledge learned *after* the initial release. He said he received a phone call from the head of research. "He told me that our long-term safety study of Vioxx was showing an increased risk of cardiovascular events compared to placebo, and the trial was being discontinued.... After analyzing the data further and consulting with outside experts, the Merck scientists recommended that we voluntarily withdraw the drug."[46]

Regardless of what Merck knew when, the voluntary withdrawal reconfirmed in a costly way its core value that patients come before profits. Merck's reputation damaged, its stock fell almost 30 percent, eradicating $27 billion in market value almost overnight—an amount much greater than the estimated net present value of the profits that Merck would have obtained from continued sales of Vioxx. Merck has been hit by lawsuits ever since; legal liabilities have cost the company up to $30 billion thus far.

Some corporate social responsibility experts argue that Merck should have never put Vioxx on the market in the first place, or that it should have at least provided up front, clear assessments of the risks associated with Vioxx.[47]

1.3 The Analysis, Formulation, Implementation (AFI) Strategy Framework

LO 1-5

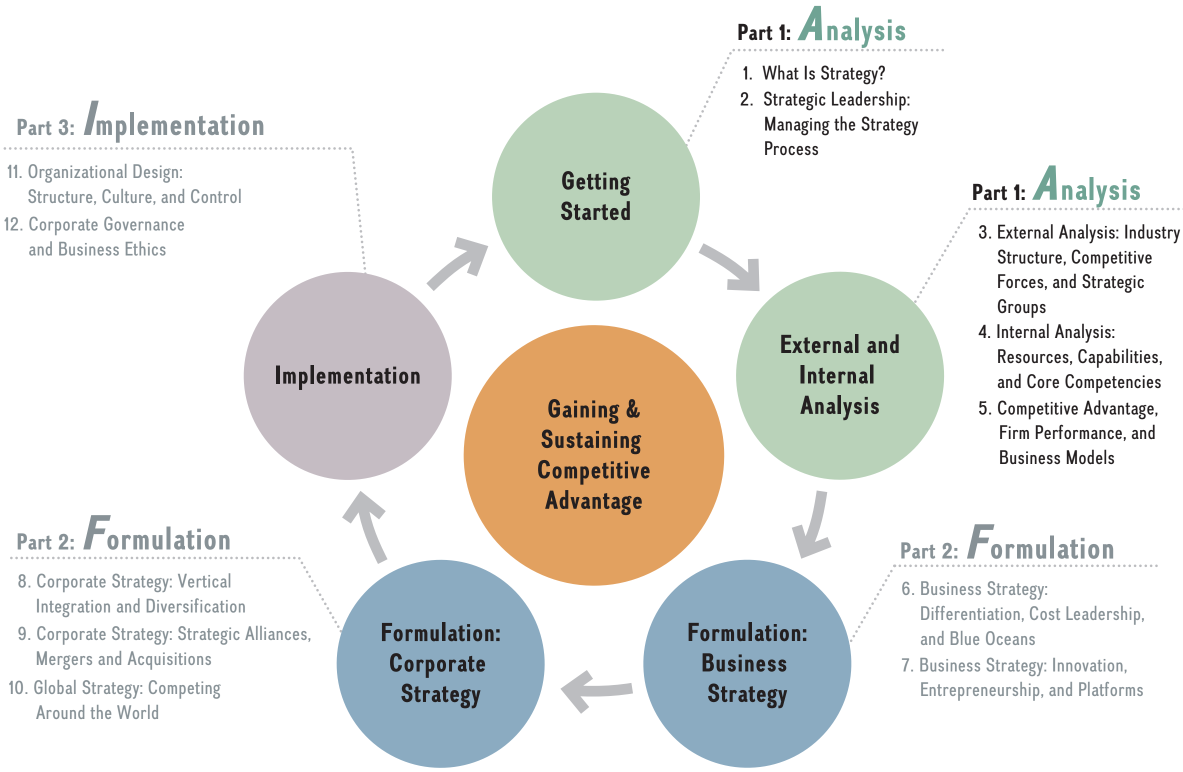
Explain the Analysis, Formulation, Implementation (AFI) Strategy Framework.

How do leaders craft and execute a strategy that enhances their chances of achieving superior performance? A successful strategy details a set of actions that managers take to gain and sustain competitive advantage. Effectively managing the strategy process is the result of

1. Analysis (A)
2. Formulation (F)
3. Implementation (I)

These three tasks are the pillars of research and knowledge of strategic management. Although we will study these tasks one at a time, they are highly interdependent and frequently occur simultaneously. Effective managers do not formulate strategy without thinking about how to implement it, for instance. Likewise, while managers implement strategy, they also analyze the need to adjust to changing circumstances.

EXHIBIT 1.4 The Analysis, Formulation, Implementation (AFI) Strategy Framework



Analysis, Formulation, Implementation (AFI) Strategy Framework
A model that links three interdependent strategic management tasks—analyze, formulate, and implement—that, together, help managers plan and implement a strategy that can improve performance and result in competitive advantage.

We've captured these interdependent relationships in the **Analysis, Formulation, Implementation (AFI) Strategy Framework** shown in Exhibit 1.4. This framework

1. Explains and predicts differences in firm performance.
2. Helps leaders formulate and implement a strategy that can result in superior performance.

Each broad strategy task raises specific *topics and questions* that managers must address. These questions and topics are listed below. They are also addressed in the specific chapters listed in Exhibit 1.4: chapters 1 to 5 address questions related to analysis; chapters 6 to 10 cover formulation; and chapters 11 to 12 cover implementation.

KEY TOPICS AND QUESTIONS OF THE AFI STRATEGY FRAMEWORK

Analysis (A)

- **Strategic Leadership and the Strategy Process.** *What roles do strategic leaders play, and how do they help shape a firm's vision, mission, and values? How does strategy come about, and what process for creating strategy should strategic leaders put in place?* (Chapter 2)
- **External Analysis.** *What effects do forces in the external environment have on the firm's potential to gain and sustain a competitive advantage? How should the firm deal with them?* (Chapter 3)

- **Internal Analysis.** *What effects do internal resources, capabilities, and core competencies have on the firm's potential to gain and sustain a competitive advantage? How should the firm leverage them for competitive advantage?* (Chapter 4)
- **Competitive Advantage, Firm Performance, and Business Models**. *How does the firm make money? How can one assess and measure competitive advantage? What is the relationship between competitive advantage and firm performance?* (Chapter 5)

Formulation (F)

- **Business Strategy**. *How should the firm compete: cost leadership, differentiation, or value innovation?* (Chapters 6 and 7)
- **Corporate Strategy**. *Where should the firm compete: industry, markets, and geography?* (Chapters 8 and 9)
- **Global Strategy.** *How and where should the firm compete: local, regional, national, or international?* (Chapter 10)

Implementation (I)

- **Organizational Design**. *How should the firm organize to turn the formulated strategy into action?* (Chapter 11)
- **Corporate Governance and Business Ethics**. *What type of corporate governance is most effective? How does the firm anchor strategic decisions in business ethics?* (Chapter 12)

The AFI Strategy Framework shown in Exhibit 1.4 is repeated at the beginning of each part of this text to help contextualize where we are in our study of the firm's quest to gain and sustain competitive advantage. In addition, the *AFI Strategic Management Process Map,* presented at the end of Chapter 1, illustrates the steps in the AFI framework in more detail. This strategic management process map highlights the key strategy concepts and frameworks we'll cover in each chapter. It also serves as a checklist for when you conduct a strategic management analysis.

We next turn to the *Implications for Strategic Leaders* section to provide practical applications and considerations of the material discussed in this chapter.

1.4 Implications for Strategic Leaders

Strategy is the art and science of success and failure. The difference between success and failure lies in an organization's strategy. A good strategy is grounded in a strategic management process that defines the competitive challenge, provides a guiding policy, and is implemented by coherent actions. A good strategy enhances the chances of achieving competitive advantage and superior performance. Moreover, strategic leaders appreciate the fact that competition is *everywhere.* Thus, you need a good strategy to deal with competition.

Strategic leaders are also mindful of the organization's internal and external *stakeholders*, because they have a vested claim or interest in the performance and continued survival of the firm. Using a *stakeholder strategy approach* enables strategic leaders to manage a diverse set of stakeholders effectively in order to gain and sustain competitive advantage.

The strategic leader also realizes that the principles of strategic management can be applied universally to all organizations. Strategy determines performance whether in organizations large or small, multinational Fortune 100 companies, for-profit or nonprofit organizations; in the private or the public sector; and in developed as well as emerging economies.

A good strategy is more likely to result when strategic leaders apply the three key tasks of the AFI Strategy Framework:

1. **A**nalysis of the external and internal environments.
2. **F**ormulation of an appropriate business and corporate strategy.
3. **I**mplementation of the formulated strategy through structure, culture, and controls.

Keep in mind that strategic leaders are making decisions under conditions of uncertainty and complexity. They must carefully monitor and evaluate the progress toward key strategic objectives and make adjustments by fine-tuning any strategy as necessary. We discuss how this is done in the next chapter where we focus on *strategic leaders* and *the strategic management process.*

CHAPTER**CASE 1** Part II

IN 2016, 10 years after Tesla's initial "secret strategy," Elon Musk unveiled the second part of his master plan for the company ("Master Plan, Part Deux") to continue the pursuit of its vision "to accelerate the advent of sustainable energy." Again, CEO Musk detailed a set of stretch goals:

1. Create stunning solar roofs with seamlessly integrated battery storage.
2. Expand the electric vehicle product line to address all major segments.
3. Develop a self-driving capability that is 10 times safer than manual via massive fleet learning.
4. Enable your car to make money for you when you aren't using it.[48]

In the updated strategy, Step 1 leverages the integration of SolarCity. The new Tesla company is now a fully integrated sustainable energy company, combining energy generation with energy storage from SolarCity. It provides energy generation via beautiful new solar roofs that look like regular shingles, but cost less, all things considered, and last longer. Tesla also offers its Powerwall to residential consumers, which allows customers to store the solar energy captured on their roofs for later use. Energy generation, therefore, becomes decentralized. This implies that consumers are able to generate and use energy without being dependent on any utility, and are able to sell back excess energy to utilities. Indeed, consumers will generate not only energy for the use of their Tesla cars but also enough to cover the energy needs of the entire house.

In Step 2, Tesla is planning to expand the lineup of its electric vehicles to address all major segments. Elon Musk excels in product development, and Tesla has several new vehicles including a compact SUV, a pickup truck, a bus, and a heavy-duty semi in development. In the spring of 2019, Tesla launched the Model Y, a compact SUV that is a smaller and much lower priced version of the Model X, starting at $39,000 (and a 230-mile range) with deliveries in spring 2021 and a higher-priced version starting at $47,000 to be available in the fall of 2020.

Tesla's new solar roof, with a Tesla car and Powerwall in the garage.
Tesla/Newscom

In Step 3, Tesla is aiming to further develop the self-driving capabilities of its vehicles. The goal is to make self-driving vehicles 10 times safer than manual driving, and thus being able to offer fully autonomous vehicles. Many industry observers expect that commercial trucks will be some of the first vehicles to drive fully autonomous, especially on interstate highways. In this fashion, the large trucks can drive 24-7, and need to stop only to recharge their batteries.

Fully autonomous driving capabilities are required for Tesla to fulfill Step 4 of the new master plan: Turn your car into an income-generating asset. The idea is to offer an Uber-like service made up of Tesla vehicles, but without any drivers. On average, cars are used less than three hours during a day.

The idea is that your autonomous-driving Tesla will be part of a shared vehicle fleet when you are not using your car. This will drastically reduce the total cost of ownership of a Tesla vehicle, and it will also allow pretty much anyone to ride in a Tesla as a result of the sharing economy.[49]

Questions

1. Do you agree with the assessment that Elon Musk and Tesla successfully fulfilled the first master plan published in 2006? Why or why not? To answer this question, apply the three-step process for crafting a *good strategy* explained in Section 1.1 (*diagnose the competitive challenge, derive a guiding policy,* and *implement a set of coherent actions).*

2. Does Tesla have a *good strategy?* Why or why not? How do you know? Consider: By summer 2019, Tesla's market cap had fallen by 30 percent to $45 billion, down from $65 billion a year earlier. Many wondered: Is Tesla in trouble?

3. Describe the rationale behind Tesla's new master plan. How does this new strategy help Tesla fulfill its vision? To view Tesla's "Master Plan, Part Deux" in its entirety, see Tesla's blog: www.tesla.com/blog/master-plan-part-deux.

4. Apply again the three-step process for crafting a *good strategy* (see Section 1.1), this time to each element of the new master plan. On which steps of the new master plan has Tesla made the most progress? Explain. Also, what recommendations would you offer Elon Musk? Support your arguments and recommendations with examples and observations from the ChapterCase.

mySTRATEGY

Who are your stakeholders?

How do you think about accomplishing your goals? One way to strategize your success is to use a version of the stakeholder impact analysis. On a personal level, your internal stakeholders might be immediate family members and close personal friends. External stakeholders could be neighbors, peers, funding sources, and managers.

A key aspect presented in this chapter is to consider the point of view of a variety of stakeholders in meeting the goals of the firm. The same logic applies to many of your own personal or career goals as well. For instance, let's say you are close to graduating from a university. How do your stakeholders view your job and career prospects? Do they want you to stay close to home? Do they encourage you to start a new business?

As noted in the chapter, stakeholders will have different points of view and also different levels of impact upon your successes or failures.

1. List your personal goals. Which stakeholders are supportive of these goals? Which are likely to try to block these goals?

2. Develop a plan to address key stakeholder concerns from each perspective. Can you find a pathway in the stakeholder analysis to build support for your key goals?

3. What would it take to implement your ideas/plans to move forward with these goals?

TAKE-AWAY CONCEPTS

This chapter introduced the concept of s*trategy* and the key role it plays in the success or failure of an organization. We learned that a *good strategy* results from a strategic management process that defines the competitive challenge, provides a guiding policy, and is implemented by coherent actions. A good strategy enhances the chances of achieving competitive advantage and superior performance. It also examines the relationship between *stakeholder strategy* and s*ustainable competitive advantage.* Finally, this chapter set the stage for further study of strategic management by introducing the *AFI Strategy Framework.*

LO 1-1 / Explain the role of strategy in a firm's quest for competitive advantage.

- Strategy is the set of goal-directed actions a firm takes to gain and sustain superior performance relative to competitors.
- A good strategy enables a firm to achieve superior performance. It consists of three elements:
  1. A diagnosis of the competitive challenge.
  2. A guiding policy to address the competitive challenge.
  3. A set of coherent actions to implement the firm's guiding policy.
- A successful strategy requires three integrative management tasks—analysis, formulation, and implementation.

LO 1-2 / Define competitive advantage, sustainable competitive advantage, competitive disadvantage, and competitive parity.

- Competitive advantage is always judged relative to other competitors or the industry average.
- To obtain a competitive advantage, a firm must either create more value for customers while keeping its cost comparable to competitors, or it must provide the value equivalent to competitors but at a lower cost.
- A firm able to outperform competitors for prolonged periods of time has a sustained competitive advantage.
- A firm that continuously underperforms its rivals or the industry average has a competitive disadvantage.
- Two or more firms that perform at the same level have competitive parity.
- An effective strategy requires that strategic trade-offs be recognized and addressed—for example, between value creation and the costs to create the value.

LO 1-3 / Assess the relationship between stakeholder strategy and sustainable competitive advantage.

- *Stakeholders* are individuals or groups that have a claim or interest in the performance and continued survival of the firm. They make specific contributions for which they expect rewards in return.
- *Internal stakeholders* include stockholders, employees (for instance, executives, managers, and workers), and board members.
- *External stakeholders* include customers, suppliers, alliance partners, creditors, unions, communities, governments at various levels, and the media.
- The effective management of stakeholders is necessary to ensure the continued survival of the firm and to sustain any competitive advantage. This is achieved through *stakeholder strategy.*

LO 1-4 / Conduct a stakeholder impact analysis.

- Stakeholder impact analysis considers the needs of different stakeholders, which enables the firm to perform optimally and to live up to the expectations of good citizenship.
- In a stakeholder impact analysis, managers pay particular attention to three important stakeholder attributes: power, legitimacy, and urgency.
- Stakeholder impact analysis is a five-step process that answers the following questions for the firm:
  1. Who are our stakeholders?
  2. What are our stakeholders' interests and claims?
  3. What opportunities and threats do our stakeholders present?
  4. What economic, legal, ethical, and philanthropic responsibilities do we have to our stakeholders?
  5. What should we do to effectively address the stakeholder concerns?

LO 1-5 / Explain the Analysis, Formulation, Implementation (AFI) Strategy Framework.

- The Analysis, Formulation, Implementation (AFI) Strategy Framework (1) explains and predicts differences in firm performance, and (2) helps managers formulate and implement a strategy that can result in superior performance.
- Effectively managing the strategy process is the result of
  1. *Analysis (A)*
  2. *Formulation (F)*
  3. *Implementation (I)*